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SUBJECT: AFGHANISTAN - PRIVATE READOUT IMF MISSION CONCLUSIONS

REF: KABUL 1746

Classified By: Ambassador William Wood for reasons 1.4(b)&(d).

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SUMMARY

¶1. (C/NF) The IMF mission visited Kabul in early May to assess the Government of Afghanistan's (GOA) compliance with the performance targets and structural benchmarks in the Poverty Reduction and Growth Facility (PRGF_ arrangement. This was the second PRGF review. The GOA met most of its benchmarks and targets except three: the benchmark related to state-owned enterprises and government agencies involved in commercial activities; the policy action to reach agreement between the Ministry of Energy and Water and the state-owned electric utility to reduce the net cost of the fuel subsidy; and the policy action to submit to Parliament a secured transactions law, a business organization law, and a negotiable instruments law.

¶2. (C/NF) While the GOA has made numerous important steps under the program, the IMF is quite concerned about increased political interference in tax and customs collections. The Finance Ministry slightly exceeded its revenue targets in 1385 taking in $575 million, but the IMF has made clear that problems in the Ministry of Finance (MOF) Revenue Department could endanger the GOA's ability to meet the target in 1386 ($715 million) and in future years. This could complicate the GOA's ability to cover its recurrent expenses, particularly as there is pressure to increase expenditures. The IMF mission delivered this message clearly to Minister Ahady and in the public concluding statement. The IMF's message may be helpful to press the GOA, perhaps at levels higher than the Minister of Finance, to avoid going down a fiscally retrogressive path where political pressures lead to losses in revenues. It will be important for the U.S. and the international community to reinforce the message that

the GOA needs to maintain political support for revenue collection. The IMF mission's review of the PRGF will come to the IMF Board in early July. There will be an IMF staff visit in July and another IMF mission will conduct the third review of the PRGF in Oct/Nov.

¶3. (SBU) The IMF concluding statement can be found on the IMF website www.imf.org/external/np/ms/2007/051007.htm. END SUMMARY.

REVENUE

¶4. (C/NF) The new IMF mission chief, Mohamad Elhage, highlighted serious concerns about the political influences in tax policy and collection, and pressures from outside the MOF that have led to a substantial loss of staff from a key revenue office, MOF's Large Taxpayers' Office (LTO). There are two revenue decisions that the IMF has highlighted: (1) Influential domestic soft drink and bottled water producers successfully lobbied President Karzai to increase the tariff from 20% to 40% on the imports of their competitors. According to the IMF Mission, this protectionist response will likely lead to increased smuggling, possibly reducing GOA revenues. (This decision has led to considerable consternation from Pepsi and other foreign soft drink companies that export to Afghanistan.) (2) A presidential decree was issued to create a 1% rate on imported raw materials and intermediate goods, and discretion on its application was left with the quasi-governmental Afghanistan Investment Support Agency (AISA). The IMF is arguing that this discretionary application reduces transparency and invites corruption as importers will lobby AISA to have their goods taxed at this low rate. The IMF is asking GOA to reverse those 2 changes in a timely manner. However, Ahady convinced them not to, arguing that only President Karzai could resolve the issue. The IMF's hope is that the critically-worded concluding statement may provide Ahady with some support to press Karzai.

5.(C/NF) On tax collection, Fund staff are concerned that forces outside the MOF are pressuring ministry staff not to collect taxes from well-connected businesses and/or to open businesses closed for non-payment. Moreover, the MOF Revenue Department, particularly LTO, has been under investigations by both the Attorney General's Office and the General Administration Against Corruption (headed by the controversial Mr. Wasifi). As a direct result of these pressures, the LTO is now down to 14 staff from 35.

¶6. (C/NF) The IMF mission chief spoke frankly with Minister Ahady about this situation. The Minister, while arguing that he opposed these two tariff change measures, didn't give the sense he was aggressively opposing them. (COMMENT: Such inaction could be a political calculation related to choosing where to expend political capital, or it could be related to his potential political aspirations. END COMMENT.) The IMF mission chief also raised these concerns with Amb. Wood in a separate bilateral meeting. The mission chief was careful to say that his concerns are about the revenue problems becoming pervasive and negatively affecting future revenue targets. His goal is to avoid that by raising the problems now. The IMF plans to closely follow the collection figures throughout the year.

FISCAL SUSTAINABILITY

¶7. (C/NF) Because expenditures have increased, the GOA reported to the Fund that it no longer expects to cover its operating budget with domestic revenue until 2012/2013. Even that projection is heavily contingent upon donors maintaining existing funding levels for the recurrent budget for the next 5 years, and off-budget programs not being brought onto the budget. (COMMENT: On the latter point, the GOA will not truly cover its recurrent costs even in 2012/2013 since substantial expenditures by donors are not being factored into the operating budget. END COMMENT.)

ARIANA

¶8. (C/NF) The IMF strongly cautioned Minster Ahady against bailing out Ariana, highlighting the lack of a clear restructuring plan and

the future costs. In the public concluding statement, the IMF states that it "urges the government not to use its scarce resources" for this purpose. Minister Ahady told Fund staff that he doesn't want to bail out Ariana, but the President does. Ahady said that Ariana needs $2 million this year, which the IMF said GOA would have to shift from existing programs in the 1386 budget. One possibility is using funding from one of the contingency funds in the budget and replenishing it later in the year if revenues exceed the IMF target. (COMMENT: President Karzai told former Ambassador Neumann during the Hajj that Ariana should be privatized. END COMMENT.)

HIPC INITIATIVE

¶9. (SBU/NF) Things are generally on track for World Bank and IMF Board meetings in early July to approve the HIPC triggers for Afghanistan and to grant HIPC Decision Point status. Under the Paris Club agreement, GOA has signed bilateral debt agreements with the U.S. and Germany and is making progress on the bilateral agreement with Russia. The only outstanding item that GOA needs to resolve to be granted Decision Point status is to clear its arrears of $1.9M with the OPEC Fund, which MOF is currently working to achieve.

WOOD